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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

No. 380.

CANADIAN RIVER GAS COMPANY, a corporation, *Petitioner,*

v.

FEDERAL POWER COMMISSION, CITY AND COUNTY OF DENVER, COLORADO, PUBLIC SERVICE COMMISSION OF WYOMING, COLORADO-WYOMING GAS COMPANY, PUBLIC SERVICE COMPANY OF COLORADO, AND COLORADO INTERSTATE GAS COMPANY, *Respondents.*

REPLY BRIEF OF PETITIONER.

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February 2, 1945.

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SUBJECT INDEX.

CASES CITED.

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REPLY BRIEF OF PETITIONER.

This reply brief is filed pursuant to leave of Court granted at the oral argument of this cause. The same abbreviations used in our opening brief are here followed.

QUESTION 1.

Jurisdiction Over Production and Gathering.

This is a vital issue from the standpoint of every interest—this Petitioner, the natural gas industry, and the public represented by the several states. It affects every phase

of this industry from the pipeline down to the royalty owner in the field. If, despite the plain words of Congress, this Court should hold that the Commission possesses rate-making authority in the area of production and gathering of natural gas, no action in the gas fields will be immune to Federal control, for he who holds the purse strings controls all.

The Commission's position on this issue is that Congress did not mean what it said in Section 1(b) of the Natural Gas Act, that it used wholly nugatory language in its attempted exclusion of these operations from the purview of that statute, and that the Circuit Court was wrong when it ruled that the Commission has no rate-making jurisdiction, express or implied, in this arena.

Indeed, though it has not appealed from the judgment of the Circuit Court, the Commission now repudiates and seeks to escape from both rulings of that Court on this issue. The Circuit Court held that there is no jurisdiction vested in this administrative body to fix rates for the production and gathering elements of Petitioner's business, but that, on the facts, the Commission had not done that. The Commission now argues that it does possess that jurisdiction, and it admits—as it must—that it exercised it in this case. By adopting this position the Commission wholly abandons the Circuit Court and leaves both its ruling and its finding dangling in midair.

In brief, the argument of the Commission is to the effect that the exception of power over production and gathering in the Act relates solely to the "activity" of producing natural gas (omitting all reference to the "gathering" function); that since the Commission has been in the habit of including producing and gathering properties and expenses in its ratemaking processes, such practice has in some fashion become hallowed by usage; that other sections of the Act authorize factual ascertainment of costs in connection with these activities; that the Commission told Congress in a report that it was its habit to include

these factors when fixing rates, and that, since Congress did not re-examine that situation when it recently amended the certification provisions of the Act, it had placed its stamp of approval on this practice. We desire to comment briefly on each of these arguments.

The Argument that the Regulation of Production and Gathering Forbidden by Section 1(b) of the Natural Gas Act Relates Only to the "Activity" of Producing Natural Gas.

The Commission concedes that this statute withholds from its regulatory powers the "activity" of producing natural gas. It illustrates its conception of such "activity" by admitting that it is debarred from control over "the determination of the drilling or spacing of wells in the field, the number of wells to be drilled in a common reservoir, proration of the production of oil or gas, or cycling or other recovery operations." (Com. Br., p. 19.)

It is significant that every activity thus enumerated relates solely to the "conservation" of natural gas and the prevention of waste in its production. It is further significant that no single element thus listed has, or could have, the slightest bearing on the other prohibited area of jurisdiction,—that of the "gathering" of gas after its "production." Obviously, it is essential to bring gas produced from numerous wells (perhaps quite distant one from the other) to a common point, where it can be delivered to the main transmission pipeline. Congress forbade the Commission to exercise authority over this necessary function by language as clear as was used in respect to mere production. Yet the Commission, by silence on the point, would apparently seek to have this process and activity wholly ignored by this Court. We cannot believe that such maneuver could hope for success.

Moreover, the only "activities" with respect to production that are now admitted by the Commission to be without the ambit of its authority are "activities" relating

to the "conservation" of natural gas in the field,—a subject universally recognized to be within the sphere of state authority and not within that of the Federal Government. This is a proposition so clearly self-evident that the citation of authorities seems unnecessary. These are matters generally recognized as being reserved to the states under our Federal Constitution, and in fact this Act so recognizes (in Section 11(a)) by providing that the Commission shall aid and assist the states in matters pertaining to the conservation of natural gas.

But even under the Commission's argument, it could hardly be imagined that control of the purse strings does not, in truth and effect, control these very items of state jurisdiction over which the Commission now disclaims authority. The Commission would include in its overall rate base at original (or "ab-original") cost all properties used in production, as well as in gathering (to which the admittedly non-jurisdictional "activities" have no application in any event). The Commission would fix and enforce a straight-jacket rate of return upon those properties, so included at such original cost. The Commission would determine what allowances should be made for working capital to carry on these operations. The Commission would determine what future capital additions should be allowed for the acquisition of gas leaseholds, the drilling of wells and the construction of gathering facilities. Yet, the Commission would have this Court believe that by thus exercising the power to fix the rates, and thus the earnings applicable to such activities, it does not, from every rational and realistic viewpoint, control or seek to control each and every activity connected directly or indirectly with the production and gathering of natural gas.

If it should be argued that these activities result in "sales" in interstate commerce for resale, and that they are therefore blanketed into the ambit of the Commission's rate-making powers, despite the express exception of "production and gathering" in the statute, the result envisaged

by the Commission can only be a multiplicity of separate and individual sale prices fixed by that body for the literally thousands of producers in the nation's gas fields, whenever they make sales to interstate pipelines. Such a result would inevitably follow the announcement of any such doctrine, yet we understand it to be the Commission's position that it neither seeks jurisdiction to engage in such multitudinous rate-fixing efforts, nor believes such action to be covered by the Act. Consistency demands that either all or no such sales in the field be held so subject, and in view of the language used by Congress we submit that none is so subject.

Finally, the Commission argues that, in any event, it possesses authority to include the producing and gathering properties and expenses in the development of rates and the establishment of allowable return in instances where a "natural-gas company" produces and gathers the gas which it later transports in interstate commerce and sells for resale. In this connection, it seems pertinent to inquire to whom Congress may have directed the exclusion of production and gathering in Section 1(b), if not to this very situation.

Congress, significantly, did not choose to delegate jurisdiction over those production and gathering operations found to "affect" or "burden" or "obstruct" interstate commerce. Obviously, therefore, if Congress by its chosen language of exclusion meant somehow to include (by silence) an exception where gas eventually enters interstate commerce, it certainly did not intend to confer rate-fixing powers as to any company *not* engaged in such interstate commerce. The jurisdictional exclusion of producing and gathering must thus relate solely to such operations when conducted by a "natural-gas company," as defined in the Act (i.e., one which is engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale. Sec. 2(6)).

If this be true, and if we were to accept the Commission's view that its jurisdiction over the producing and gathering properties of a natural-gas company devolves from the fact of later interstate commerce, the words of Section 1(b) must be read out of the Act as mere surplusage.

The Argument that the Language of Exclusion in Section 1(b) is Surplusage.

As a matter of fact, the reading out of the Act of the exclusion language of Section 1(b) as largely, if not wholly, surplusage is precisely what the Commission now argues. It quotes from a Report of the House Committee which reported the Bill (H. R. 6586, 75th Cong., 1st Sess.) which became this Act, but a reading of this quotation shows that the statement about surplusage had reference to the local distribution rather than the production and gathering of natural gas (Com. Br., pp. 20-21). Contrary to the impression which the Commission seeks to leave with the Court in this regard, the entire legislative history of this statute (discussed at length in the brief of the Independent Natural Gas Association of America, *amicus curiae*) discloses how clearly Congress intended *not* to vest in the Commission *any* rate-fixing powers in *any* case over the production and gathering of natural gas. As there shown, the then Solicitor for the Commission, as well as the Chairmen of the Congressional Committees having charge of the bill, so stated in unequivocal language. This factor was unquestionably to be left to "competitive forces in the gas fields."

The Argument that the Commission's Habit in this Direction Now Has the Force of Law.

It is said that the Commission has all along habitually included producing and gathering properties and expenses in fixing the rates of natural gas companies, and that this practice has been hallowed by usage until it has been clothed with the force of law. It is said that this Court did not

strike down such action in the two rate cases which have already arisen under this Act, and that therefore the possession of this power has been judicially validated.

The cases in question are those of *Federal Power Commission* v. *Natural Gas Pipeline Company of America*, 315 U. S. 575 and *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U. S. 591. Suffice it to say that in neither of those cases was this point even raised by the companies under consideration. It would be heterodox doctrine, indeed, to hold that in such a situation this Petitioner is now barred from making its contention. The acquisition of jurisdiction over one entity because of default or waiver by another could hardly be urged, since even waiver by the Petitioner itself at some stage of the proceeding could not—under universally recognized principles—be deemed to vest jurisdiction in the Commission over an element excluded by Congress from the vested powers.

The Argument that Other Sections of the Act Authorize the Commission to Ascertain the Cost of Production and Gathering Facilities.

As was stated in Petitioner's opening brief, we are not here questioning the inquisitorial powers granted to the Commission under Sections 5(b), 9(a), 10(a), 11(a) or 14(b) of the Act. Even a cursory examination of these sections would show that they grant only powers to investigate for the purpose of aiding the Commission in the exercise of its jurisdiction over facilities and operations expressly granted by Congress, or in aid of the exercise of jurisdiction reserved to state regulatory bodies, or in aid of legislation. There is nothing new or novel in the extension of necessary powers for this purpose. Their inclusion in the Act for this purpose is perfectly consistent with the production and gathering exclusion clause set forth in Section 1(b) of the Act. When read and interpreted in this manner the Act as a whole, with respect to the Commission's jurisdiction over production and gathering, makes sense, and it is not necessary to indulge in any leger-

domain which would relegate the exclusion clause in Section 1(b) to the status of mere surplusage.

Sections 6(a) and 6(b), relied upon by the Commission, authorize it to investigate and ascertain the original cost of properties of natural gas companies, and to require the filing of inventories and statements of original cost. *These subsections do not even mention production or gathering properties*, and accordingly contain no support for the Commission's claim that it may exercise rate regulatory jurisdiction over such properties or operations.

The power granted to the Commission in Section 14(b) to determine the adequacy or inadequacy of gas reserves is essential in many cases to determine the proper rates of depreciation or amortization to be allowed upon transmission facilities used in transporting natural gas in interstate commerce. The powers granted to the Commission in Section 14(b) with respect to delay-rentals as compensation for unoperated lands and leases are of importance to the Commission in the maintenance of uniform systems of accounting.

Notwithstanding the implications which the Commission attempts to draw from Section 14(b), it will be noted that the title to Section 14 as a whole and as enacted by Congress, is as follows: "*Investigations by Commission; attendance of witnesses; depositions.*"

The Commission (Com. Br., p. 38), in referring to the legislative history of Section 14(b), alludes to the fact that it was taken from H. R. 5711 (75th Cong., 1st Sess.) which was under consideration at the same time as H. R. 4008 of the same Congress and Session. The circumstances surrounding the transferral of this subsection from H. R. 5711 bear out our contention that the authority given the Commission in Section 14(b) was merely a power to investigate in connection with the determination of depreciation charges and other accounting matters. The subsection, as contained in H. R. 5711 (with the exception of the requirement for the filing of lease and royalty agreements), was in

Section 16 of that bill, entitled "Rates of Depreciation." A provision requiring the filing of lease and royalty agreements was contained in Section 12 of H. R. 5711 entitled "Rates and Charges" (Hearings on H. R. 4008, 75th Cong., 1st Sess., pp. 13, 15). However, when the House Committee reported out H. R. 6586 (the bill which became the Natural Gas Act) the provision requiring the filing of lease and royalty agreements was not included in the *rate* provisions (as contained in H. R. 5711) but was combined with the provision permitting the Commission to determine the adequacy or inadequacy of gas reserves (which had been under the "Depreciation" section of H. R. 5711) and included both provisions in what is now Section 14(b) under the general heading of "Investigations."

The Argument that the Uniform Administrative Interpretation of the Commission Consistently Has Been to Consider Production and Gathering Facilities in Fixing the Rate Base, and the Commission Has So Reported to Congress.

The purpose and value of this argument, even though sound from a factual standpoint, is not clear. However, it is readily answered in any event. The Commission quotes a portion of its Twentieth Annual Report to Congress for the year 1940, as follows:

> "4. *Gas reserves.*—As the natural-gas industry is an extractive industry, *one of the important elements of cost which must be determined pertains to the exhaustion of the service life of the properties due to the depletion of the natural-gas reserves which the properties were constructed to produce or transport.* The Commission's geologists have been engaged in estimating the volume of gas reserves in a number of important fields, among them the Panhandle field in Texas, the Hugoton field in Kansas and a major portion of the fields located in West Virginia, Pennsylvania, and New York. A few years' difference in the estimated life of available gas reserves supplying a given market may

make a large difference in the rates which can be justified for that area.' [Emphasis supplied.]" (Com. Br., pp. 27-28.)

The Commission fails to quote, however, a section of the same report immediately preceding the above, which reads as follows:

"3. *Service life.*—Because of the lack of adequate data in the industry for the determination of reasonable depreciation allowances, it has been necessary to have members of the staff make comprehensive studies of the service lives of various kinds of depreciable property." (p. 77.)

It is quite obvious that in Item 4 of its Report the Commission is talking about investigations of gas reserves for the purpose of determining depreciation or amortization rates on transmission facilities pursuant to the authority granted to it in Sections 9(a) and 14 of the Act. There is not even a hint here to Congress that the Commission was at that time claiming full rate regulatory jurisdiction over production and gathering. As a matter of fact, in the same report, under the title "*Commission recognizes limits to jurisdiction,*" the Commission has the following to say with respect to its rate regulatory powers over producing operations:

"During the year the Commission suspended a proposed increase in rates filed by the Columbian Fuel Corporation for natural gas sold to the Warfield Natural Gas Co. for resale. Following hearings regarding the suspension, the company filed a special petition requesting a hearing as to the jurisdiction of the Commission over the particular sale and over the Columbian Fuel Corporation generally.

"Widespread interest developed concerning this question of jurisdiction. The Public Service Commissions of Kentucky and West Virginia, the Mid-Continent Gas & Oil Association, the Independent Petroleum Association of America, and the National Association of Railroad and Utilities Commissioners all requested permission to intervene or to file briefs. The Commis-

sion granted opportunity for oral arguments on the question by interested parties, which it heard sitting *en banc*.

"In its opinion and order the Commission dismissed the entire proceedings, finding that the Columbian company was engaged only in the production of gas and that the Commission had no jurisdiction over the arms-length sale of natural gas at the well mouth."

If it were a matter of common knowledge to the members of Congress and in the industry and elsewhere that through administrative practices and interpretation the Commission had acquired rate regulatory jurisdiction over production and gathering by default, then certainly this fact escaped the notice of the Circuit Court, because, as heretofore stated, that Court held that the Commission does not have express or implied rate regulatory jurisdiction over the production and gathering of natural gas. Such holding found ample support in the *Natural Gas Pipeline case* and *Hope case* heretofore decided by this Court and quoted in petitioner's opening brief.

The Argument that Congressional Approval of the Administrative Interpretation of the Act May be Inferred from the Fact that Section 7 Was Amended by Congress in 1942 With No Other Legislative Change in the Act.

Reference to Section 7 of the Act will show that it has to do with the issuance of certificates of public convenience and necessity by the Commission. It has no relation whatsoever to the production or gathering of natural gas. Certainly, an amendment to an unrelated section of the Act by Congress cannot by any theory of acquiescence or otherwise serve to bind Congress to the Commission's interpretation or administrative practices with respect to other sections of the Act. If this were true neither Congress nor the Courts nor anyone else could with certainty determine the status of the law.

The argument is false in any event, because the amendment in question to Section 7 was enacted in February 1942. The decisions of this Court in the *Natural Gas Pipeline case* and the *Hope case* were handed down subsequent to that date. Likewise, the decisions of the Commission with respect to all of the natural gas pipeline cases (including that of Petitioner) now before this Court were handed down by the Commission subsequent to that date. As heretofore stated, the Circuit Court in this case has held that the Commission does not have rate regulatory jurisdiction over production and gathering, and that such holding finds ample support in the decisions of this Court in the *Natural Gas Pipeline case* and the *Hope case*.

If Congress is to lose its powers by acquiescence, or is to have its laws repealed by administrative practice, must its alertness and diligence be directed to the decisions of the courts or to the administrative practices and interpretations of the bureaus?

The Commission alludes to the circumstance that Section 7 (the certificate section) of the Act was amended by Congress in 1942, and apparently seeks to convey to the Court the impression that Congress approved its administration of the Act, including assumption of jurisdiction over production and gathering (Com. Br. 28). Neither the general reference made by the Commission, nor the specific references to pages of the hearing before the House Committee, support the Commission's contention. We have diligently examined the references given by the Commission and find no support whatever for its statements. At pages 34-35 of the hearing Mr. W. A. Dougherty, appearing for certain natural gas companies, was asked by Congressman Wadsworth whether the matter of regulation, since the passage of the Act, was still in its formative stages, and Mr. Dougherty responded to the general effect that it was, that the Commission was then in the process of considering its first major rate proceeding, and that within the next year or two certain major problems, including jurisdictional ques-

tions, would undoubtedly be determined. At pages 40-46 of the hearing, also referred to by Respondents, Mr. John E. Benton, General Solicitor for the organization of state regulatory commissions, testified and objected to a contention made by a member of the staff of the Commission that the Commission could control the intrastate operations of a Kentucky company. Mr. Benton, under interrogation by Congressman Boren, stated that the Commission had not yet taken jurisdiction over local distribution; and, in respect to the Kentucky case, was specifically interrogated by Congressman Boren as follows (Hearing, p. 42):

> "Mr. Boren. Just one interruption there. Do you mean the Federal Power Commission assumed jurisdiction over the gathering lines in the producing area?
> "Mr. Benton. No, I do not, Mr. Congressman."

At pages 60-61 of the hearing, also cited by the Respondents, testimony was given by Mr. J. J. Hedrick, attorney for the Natural Gas Pipeline Company of America and under interrogation on general matters by Congressman Boren, stated that there had been no appreciable expansion of pipeline facilities since the passage of the Act; that his company had been in a rate case with the Commission for two years, which was then pending in the courts and had not at that time been completed.

We have summarized the portions of the hearing on H. R. 5249, relied upon by the Commission in its brief, because we believe that it refutes the Commission's contention that at such hearings "the Commission's administration of the Act was fully explored" and apparently tacitly approved by Congress. We cannot avoid the observation that the Commission has apparently become desperate when it attempts to sustain its claim of jurisdiction over production and gathering by citing and relying upon legislative material in no way pertinent and containing not one iota of support for its contentions.

The Answer is to Use the Appropriate Field or Commodity Value of Gas as a Measure of Allowable Expense.

In its brief before the Circuit Court, the Commission took the position that the exercise of rate regulatory jurisdiction over production and gathering was "indispensable" to the ~~exercise of its~~ jurisdiction over interstate transportation and sales. In Petitioner's opening brief before this Court, two answers were made to this contention, first, that indispensability of jurisdiction is legally immaterial if Congress has in fact withheld rate regulatory jurisdiction from the Commission; and second, that rate regulatory jurisdiction over production and gathering is not, in any event, "indispensable" because the Commission has a perfectly logical and practical starting point for the purposes of exercising its jurisdiction over interstate transportation and sale of gas, i.e., *the field price of gas at the well-head and at the end of the gathering operation for pipeline purposes.*

The Commission does not emphasize the indispensability argument in its brief filed in this Court, but it does contend that the field or commodity price concept is unrealistic; that the only substantial markets are those of the large pipelines which fix their own prices; and that the supply exceeds the demand. (Com. Br. 15.)

There is no evidence in this record to support any such statements. The case of *Thompson v. Consolidated Gas Co.*, 300 U. S. 55, cited by the Commission to support its views, is based upon a factual situation existing in 1935, ten years ago, and does not in any sense represent present conditions in the field. The only evidence in this record as to the field or commodity value of gas for pipeline use in the Texas Panhandle Field was presented by Canadian through its witness Superintendent R. A. Ford, who had been connected with Canadian's field operations from their commencement in 1928. (R., V. 6, 3255-3281.) A review of his testimony discloses that he investigated every material contract for the purchase of gas by pipelines in the Texas

Panhandle Field to determine the current prices applicable to the purchase and sale of gas in arm's-length transactions; that he investigated and determined the price being paid generally to royalty owners for their portion of such gas under leases requiring royalty settlements on a current market basis; and that, based upon such investigations, he had found that the going field price for natural gas in the Texas Panhandle Field for pipeline uses, was a minimum of 4¢ per MCF at the well-head and 7¢ per MCF at the end of Canadian's gathering system (both prices at 16.4 pounds pressure base).

There is now, and has been over a long period of years, a definite field or commodity price for natural gas *for pipeline use* in the Texas Panhandle Field. As a matter of fact, thirty days after the first foot of gas was produced and sold by an operator for pipeline use under a lease requiring settlement of the royalty owner's portion of such gas on a current market value basis, it became necessary to determine such current market value for that use. There are literally hundreds of such leases and literally thousands of such royalty owners in the Texas Panhandle Field who have a vital interest every month in the correct determination of such market value as a measure of the payments they are entitled to receive by reason of gas production. Determination of such field market value has been a matter or day-to-day practice in the Texas Panhandle Field for a period of over 25 years. In many cases, where the producer and the royalty owner have been unable to agree upon market value, the parties have resorted to litigation and the courts. After considering all of the circumstances and conditions, the courts have then determined such field or commodity value.

Since about 1931 the State of Texas has had a so-called Severance Tax Law which levies annually a tax upon the market value of gas produced at the mouth of the well. (H. B. 8, Chap. 184, Acts of 47th Texas Legis., Regular Session 1941, P. 269, and prior laws.) Obviously, in the

assessment of such tax, it is necessary for the State of Texas to investigate and determine annually the field price or market value for gas at the well-head, which it has done regularly.

Over a long period of years lessors and lessees, producers and royalty owners, as well as the courts and the State of Texas for tax purposes, have had no difficulty in ascertaining the current market value of gas produced in the Texas Panhandle Field. It would seem that the Commission stands alone in its perplexity and professed inability to obtain the answer to a problem which others have found relatively simple. As a matter of fact, if the Commission really entertains any special concern about the *bona fides* of the market value of gas produced in the Texas Panhandle Field and used in the pipelines which transport it in interstate commerce, we would suggest that the Commission may well calm its fears and rely upon the eternal vigilance of independent producers, royalty owners and the State of Texas to make certain that such market values are fair and reasonable at all times.

QUESTION 2.

Impropriety and Invalidity of Including Natural Gas Leaseholds in a Rate Base on an Original Cost Formula or Prudent Investment Theory.

The Commission's treatment of this question is found at pages 29 to 36 of its brief.

We shall in summary form reply to the attempted answer of the Commission to our position that even assuming that the Commission has rate regulatory jurisdiction over production and gathering, it is improper under the circumstances disclosed in this case to include Canadian's natural gas leaseholds in a rate base at the Commission's conception of original cost.

1. On pages 29-32 of its brief, the Commission intimates that it considered and rejected Wallace's testimony as to

the present fair market value of Canadian's gas leaseholds on its merits, and cites *Dayton Power & Light Co.* v. *Commission*, 292 U. S. 290, 299, in justification.

This is not the case, as clearly appears from the Commission's Opinion. The Commission stated in its Opinion, "Commission restricted its plant studies to original cost and offered evidence of that character." (R., V. 1, 148.)

The Commission then continued, "We find, therefore, in accordance with the provisions of Section 6 of the Natural Gas Act and under the record in this proceeding, no necessity exists to consider other factors than original cost of the properties and service." (R., V. 1, 148.)

A search of the Commission's Opinion will disclose absolutely no discussion of, or even reference to, the evidence in the Record relating to the market value of Canadian's gas leaseholds. This evidence is entirely ignored.

This treatment is entirely consistent with the announced policy of the Commission to use original cost (as defined by it) in the rate base to the exclusion of all evidence of value. This policy of the Commission has been expressly and openly stated time after time by the Commission.

In *City of Detroit, et al.* v. *Panhandle Eastern Pipe Line Co., et al.*, 45 P. U. R. (N.S.) 203, the Commission states:

> "We held in the Chicago District Electric Generating Case that under Section 208(a) of the Federal Power Act (the provisions of which are identical with Section 6(a) supra), that reproduction cost evidence is inherently fallacious, and should be disregarded under that statute.
>
> "It is not deemed necessary to discuss at great length the defects and vagaries of reproduction cost evidence. The manifold reasons why such evidence is fallacious, and is obstructive of the regulatory process, have been fully expounded by members of the Supreme Court and by this Commission.
>
> "Moreover, in the light of the many expressions emanating from the highest court in the land and the opinions of competent experts in the regulatory field,

it seems evident that Congress recognized the fallacy of the reproduction cost doctrine, and sought by the enactment of Section 6(a) *to shelve that illusory concept as a requisite in rate making.*" (Italics supplied.)

Consistent with that announced policy this Court will note from the briefs in the *Panhandle Eastern Pipeline* case (No. 296, this Term), which was argued at the same time as this case, that the Commission in the *Panhandle Eastern Pipeline* case refused to permit the introduction of evidence of the market value of the gas leaseholds there involved.

Likewise, in the *Cities Service Gas Company* case, decided by the Commission on July 28, 1943 (50 P.U.R., (N.S.) 65), which is now pending on review in the Circuit Court of Appeals for the Tenth Circuit in Case No. 2813 of that Court, the Commission again announced its adherence to this policy in the following language:

> "At the threshold we are met with the Company's contention that the trial examiner improperly excluded evidence of * * * so-called 'fair value' of the properties. Our view as to why such evidence should be excluded has been stated in earlier opinions. (Note: of the Commission.) * * * Moreover, the Company's estimates of * * * so-called 'fair value' are at best synthetic figures not taken from the books and records. They do not purport to represent actual cost or investment. Upon such record, we find that no necessity was shown to exist for the consideration of evidence of * * * 'fair value' in this proceeding."

It is absolutely clear, therefore, that the Commission did not consider and reject in this case the evidence as to the fair market value of Canadian's leaseholds on the merits, but ignored such evidence entirely in adherence to its consistently announced policy that all evidence of this nature is immaterial.

It thus follows that the opinion in the *Dayton Power & Light Company* case is inapplicable because in that case

the evidence of fair value was considered on its merits and rejected on its merits.

Finally, the evidence of fair value in the *Dayton* case which was so considered and rejected on its merits was entirely different from the evidence of fair value in the case at bar. In the *Dayton* case the opinion evidence as to value there rejected was based upon a regulated price and continued connections with regulated pipelines, and the Court's position was that the question of value of the leaseholds was so closely connected with the price that might be received from time to time under regulation that the opinion must necessarily be conjectural. In the present case, on the contrary, Wallace (R., V. 6, 3181-3254), after analyzing each of Canadian's leaseholds in detail, including the date of completion of the wells, the initial open flow and rock pressure, the present open flow and rock pressure, and the production to date, and after testifying as to actual sales of other acreage in the same Texas Panhandle Field, gave his opinion as to the market value of each of Canadian's leaseholds and as to the aggregate value of all of them. In doing this, *Wallace expressly stated that he had not considered as a value factor the fact that the wells were connected to pipelines and had not considered any contracts which Canadian had for the sale of its gas and that if Canadian's acreage were available for a sale it could unquestionably secure an outlet for its gas, exclusive of any pipeline in the field.* (R., V. 6, 3191, 3194)

This clearly distinguishes the leasehold market value evidence in the present case from that which was introduced, considered and rejected on its merits in the *Dayton* case. We submit therefore that it was the duty of the Commission in the present case at least to consider Wallace's testimony on its merits, which it did not. If it had, we believe the difference in the character of Wallace's testimony and that considered in the *Dayton* case would have been easily recognized.

The simple fact is that the fair market value of Canadian's gas leaseholds was established in this case by un-

controverted evidence which has been entirely ignored by the Commission in blind adherence to its so-called original cost or prudent investment rate base policy.

2. In a footnote on page 30 of its brief, the Commission disputes the statement in our brief that Canadian's *bare leaseholds* have been included in the Commission's rate base at something less than $1,000,000; and the Commission has attached to its brief as Appendix D a sheet setting forth certain figures which, according to the Commission, refute our statement.

Of course, as a practical matter it does not make much difference which one of us is correct in this connection, for even if the Commission is correct, admittedly the leaseholds have been included in the Commission's rate base at much less than their actual value and at much less than Canadian's actual original cost. However, we cannot concede that the Commission is correct. This Appendix D that the Commission has attached to its brief is not a copy or reproduction of any testimony or exhibit introduced in evidence in this case. Where the Commission may have secured these figures we do not know. We do know, however, that the Commission's Opinion is in such general language, with no detailed supporting findings for the ultimate findings, that when the Opinion was handed down we requested the Commission to allow us to examine its staff's working papers or otherwise to inform us as to the nature of the underlying figures used by the Commission in arriving at its ultimate figures as set forth in its Opinion. Our request was refused.

Furthermore, it appears from the Appendix D attached to the Commission's brief that it has added a number of extraneous items to the "*bare leasehold cost*," which we are discussing in our brief. Finally, we submit that the figures used in our brief are accurate and entirely justified by the Record. In fact, the $1,604,020.61 starting point figure is taken directly from the Commission's own Exhibit 146, sheets 62-64, R., V. 5, 2717, 2721, and the $653,681.00 deduc-

tion made from this starting point figure for depletion is taken directly from the Commission's Opinion. (R., V. 1, 186).

3. The Commission makes the same criticism of the uncontradicted evidence in this case establishing the market value of Canadian's gas as a commodity at the wellhead and at the end of the gathering system as it did to Canadian's evidence covering the fair market value of its leaseholds. We make the same reply to this contention as we have made above with reference to the Commission's treatment of the uncontradicted evidence in this case which established the market value of Canadian's leaseholds. The Commission did not consider and reject on its merits the evidence in this case as to the commodity value of Canadian's gas, but ignored such evidence entirely as a matter of legal principle. The evidence in this case on the commodity value of Canadian's gas is not only evidence introduced by Canadian, but also is corroborated by evidence introduced by the Commission itself. It is based upon actual arm's-length contracts for the sale and purchase of gas in the Texas Panhandle Field and upon royalties payable on a market value basis in that field pursuant to arm's-length negotiated leases and contracts. This evidence is not limited to Canadian's gas, but is fieldwide. (R., V. 6, 3255-3281.)

4. On pages 32 *et seq.* of its brief, the Commission indicates that there can be no commodity market value of Canadian's gas. It volunteers the statement, not supported by any evidence in the Record, that the only markets which are available are located at distant points; that the major pipeline companies control these markets; and that if these particular markets were lost there would be little if any commodity value to Canadian's gas or to other gas in this field, and the Commission in its brief concludes on page 34 with the astounding statement that "prevailing prices accordingly do not establish a commodity value."

We have replied to this desperate argument at the conclusion of our reply on Question 1, *supra*, and will not repeat our reply here. In addition thereto, it is a fact that in 1939 (the test year applied by the Commission in this case) substantially less than 50 per cent of the total gas production in the Texas Panhandle Field was sold to and utilized by pipelines for light and fuel purposes. Of the gas so sold and utilized by pipelines, a substantial portion was confined to intrastate commerce; and of the gas that moved by pipeline in interstate commerce, a large portion was sold by the pipelines directly to consumers. Neither intrastate sales nor direct sales in interstate commerce are subject to the jurisdiction of the Commission. (See 1940 Annual Report of Railroad Commission of Texas, covering Panhandle Oil and Gas Field, Table VIII.)

5. On page 36 of its brief, the Commission makes the following amazing statement:

> "Finally, if the commodity price rather than cost were adopted by the Commission there would no longer be any necessity for treating the gas business as presenting any peculiar hazards. As a result, the transmission facilities, which constitute the larger portion of the pipe lines investment, would be entitled to a lower rate of return than 6½%."

In the first place, this statement carries with it the implicit admission that the production of natural gas is an extra hazardous business and that a 6½ per cent rate of return on an original cost rate base is fair only for a business involving fewer hazards. From this it logically follows that the 6½ per cent rate of return allowed by the Commission in this case is inadequate as to the admittedly hazardous portion of Canadian's business, namely its production and gathering. Two-thirds of the entire rate base allowed by the Commission in this case covers production and gathering properties. So, by the Commission's own admission, an inadequate rate of return has been allowed on over $6,000,-000, which constitutes the amount at which Canadian's pro-

duction and gathering properties have been included in the rate base on the Commission's prudent investment or original cost theory.

Again in this quoted paragraph the Commission admits that the transmission business is a hazardous business where the production and gathering properties are included in a rate base on an original cost basis, but states that the transmission business would become at least less hazardous if the commodity price of natural gas should be adopted. Inasmuch as the Commission has included Canadian's production properties in the rate base on an original cost basis and thus made the transmission end of the business hazardous, it follows from the Commission's own admission that the 6½ per cent rate of return allowed on the amount included in the rate base for transmission properties is also inadequate. **Moreover, on its rate base, two-thirds of which represents production and gathering properties even on the Commission's theory of original cost, Canadian has been grossly wronged by the Commission in its allowance of an over-all rate of return of 6½ per cent, because the Commission has simultaneously allowed Colorado Interstate (No. 379, this Term), and Colorado-Wyoming Gas Company (No. 575, this Term), a 6½ per cent rate of return on their entire rate bases, and neither of such companies owns any gas producing or gathering properties whatsoever.**

6. The Commission states on page 35 of its brief that the original cost theory adopted by the Commission is "fair alike to consumers and natural-gas companies".

In our opening brief we believe we have demonstrated that the inclusion of natural gas leaseholds in a rate base at their original cost (which to the Commission in this case means the original "wild-cat" acquisition cost twenty to thirty years ago to oil-seeking predecessors) cannot possibly, except by accident, result in fair and reasonable rates either to the consumers or the natural gas companies or other owners of the production. We do not deem it necessary to repeat our demonstration of this truth here.

In the *Panhandle Eastern* case (No. 296, this Term), the Commission admits that when a transmission company purchases the gas which it transports, the Commission uniformly has allowed the purchase price of the gas so purchased as an expense item without question. No satisfactory answer is given as to why the commodity value of the gas at the well-head or at the end of the gathering system could not be used in the instances where the owner of the transmission system is also the owner of the production and gathering properties, if it is proper to use that commodity value where the gas is purchased. Obviously, there can be no rational answer to this question.

Of course, we are not contending that the Commission, whether the gas is purchased from a third person or is produced by the owner of the transmission system, should not have the right to test the price which is claimed to be the going commodity value. We think it perfectly proper for the Commission to test the claimed commodity value in any way it wants, if there is any reason to suspect that the claimed value is not the true commodity value. It can test this claimed commodity value by the use of any method which may be thought to have a legitimate bearing on the facts. But to discard commodity value entirely in favor of a value based upon the Commission's conception of original cost, as we have pointed out in our opening brief, cannot possibly result in just and reasonable rates from the viewpoint of either the consumer or the owner of the gas.

If the Commission's rate reduction order in this case is permitted to stand, based as it is upon an application of the Commission's original cost theory, Canadian will be receiving only approximately 2.1 cents per MCF for its gas at the wellhead as against not less than a 4-cent per MCF commodity market value. (R., V. 6, 3255-3281.) Surely, there can be no justification for this discrepancy. It is discriminatory as between gas which may be transported through a transmission system owned by the producer of the gas, as against gas which may be sold by the producer of the gas to

a third party owner of the transmission system. Such a plan must necessarily result in different prices to different consumers for the same gas produced from the same field and even from the same lease, depending upon whether such consumer is purchasing from one who produces the gas or from one who buys it from the producer.

The Commission seeks to find support for its use of original cost in lieu of commodity value in the opinion or opinions of this Court in the *Hope* case. No support for the Commission, we submit, can be found in the *Hope* case. We have discussed the *Hope* decision in connection with Question 1. The first answer is that this question was not involved in the *Hope* case. All that the *Hope* case does, even in the majority opinion, is to rule that the Commission is not bound to any particular formula. Moreover, when this Court said that the Commission was not bound to the use of any particular formula, it coupled that statement with the qualification that the formula to be adopted must be just and reasonable under the circumstances of the case. That is all we are asking for here. Clearly, the Act contains no mandate that the Commission shall not use commodity value instead of original cost. This is evident from the language of the Act and also from the administrative practice of the Commission in using the commodity value where the gas is purchased.

Our position is that the use of original cost in determining the value of the gas leaseholds as against the use of commodity price of the gas cannot result in just or reasonable rates, which is the very purpose of the Act, and cannot be sustained by recourse to any "end result" or "rate impact" principle, either from the viewpoint of the owner of the gas or the consuming public.

Finally, we submit that under the facts disclosed by the Record in this case, the use of original cost for the inclusion of Canadian's gas leaseholds in the rate base and on the Commission's conception of original cost was an arbitrary and capricious exercise of any general discretionary power

which the Commission may have, and for this reason, if for no other, violates the due process clause of the Fifth Amendment to the Constitution of the United States.

> *United States v. Chicago, Milwaukee, St. Paul & Pacific R. R. Co.*, 282 U. S. 311; 75 L. Ed. 359, 365;
> *Railroad Retirement Board v. Alton R. R. Co.*, 295 U. S. 330; 79 L. Ed. 1468, 1474;
> *Nashville, Chattanooga & St. Louis Ry. v. Walters*, 294 U. S. 405; 79 L. Ed. 949, 955;
> *Nebbia v. New York*, 291 U. S. 502; 78 L. Ed. 940, 950;
> *K. & L. Oil Co. v. Oklahoma City, et al.*, 14 Fed. Supp. 492, 494.

QUESTION 3.

Canadian's Actual Original Cost of Leasehold Properties.

The Commission takes the position in its brief (pp. 37-53) that the full $5,000,000 paid in cash by Canadian to Amarillo for the latter's gas leaseholds, rights and wells at the inception of the Denver Project in 1927-28 should not be considered or allowed in determining Canadian's original cost for rate base purposes, because

(1) Either the transaction which resulted in the acquisition of such properties was simply an intercompany arrangement between two wholly-owned subsidiaries of Southwestern; or

(2) There was a pooling of interests as in the *Niagara* case (135 F. (2d) 787), and Southwestern was in reality merely advanced or loaned $5,000,000 on its future profits from Colorado Interstate.

The Record does not support either of the above alternative assumptions. The formal transfer of properties was ultimately between two wholly-owned subsidiaries of Southwestern, but the basis for that transfer, and the agreement to buy and sell, as well as the consideration to be paid, had its genesis in the original project agreement between three

non-affiliated parties. The terms of such sale and the consideration to be paid were agreed upon as a result of prolonged arm's-length bargaining between Southwestern, as a representative of Amarillo, on the one hand, and Cities Service and Standard, on the other. There was every incentive on the part of Standard and Cities Service to fix the consideration at the lowest possible figure, while on the other hand there was every incentive on the part of Southwestern to secure the greatest possible sum for the properties in question. Thus this transaction was something more than an intercompany arrangement between two subsidiaries of the same parent. The consideration actually paid in cash for such properties resulted from negotiations that absolutely guaranteed a fair price, from the standpoint of public and every other interest. (See Canadian's brief, pp. 52-72.) This being true, there is no occasion here to apply the "no profits between affiliates" rule. It is fundamental that where the reason for a rule fails, the rule itself will not be applied.

The Record in this case establishes without dispute the following:

1. There was an actual purchase and sale of gas leaseholds, rights and wells which was a condition precedent to the establishment of the Denver Project. There would have been no Denver Project unless such production properties had been acquired from Amarillo.

2. The $5,000,000 paid in cash to Amarillo by Canadian for such properties was not an advance or loan of a portion of Southwestern's share of future profits in any joint enterprise, because:

(a) The project agreement between the parties of April 5, 1927 (Memorandum of Stipulations, Exhibit 1, R., V. 1, 381-400) completely contradicts any such interpretation. This agreement, as well as all other evidence in the Record on the subject, clearly and indisputably proves that the parties agreed that Amarillo should sell its gas leaseholds,

rights and wells to Canadian and should receive $5,000,000 in payment therefor, *provided it was able to clear its titles to the satisfaction of the project participants* (R., V. 5, 2914-2915).

(b) With respect to the Commission's "advance" theory (Com. Br., 42); or the "loan" theory (Com Br., 52), an advance or loan carries with it a definite offsetting liability to repay the sum advanced or loaned. This is true in any parlance,—legal, accounting, commercial, or otherwise. Neither Southwestern nor Amarillo had any such liability in this case. The money paid belonged irretrievably to Amarillo, with the unrestricted right to keep and utilize the same for any purpose or purposes it might see fit.

(c) If the Project had failed entirely, or had become hopelessly insolvent, still Amarillo would have retained as its own the full $5,000,000 paid, without any obligation whatsoever on the part of Amarillo or Southwestern to repay.

(d) If we assume *arguendo* that the $5,000,000 did constitute an advance or loan on future profits of Colorado Interstate, then only $42\frac{1}{2}$ per cent of such profits could be deducted from profits accruing to Southwestern (after payment of dividends on the outstanding preferred stock), because Southwestern owned only $42\frac{1}{2}$ per cent of the common stock of Colorado Interstate. If this sum was to be repaid out of profits of Colorado Interstate, then it is obvious that the remaining $57\frac{1}{2}$ per cent would have to be repaid from the profits of the other non-affiliated stockholders of Colorado Interstate.

(e) The fact that Canadian paid the purchase price for the gas leaseholds, rights and wells acquired from Amarillo out of the proceeds of its first mortgage bond issue is of no material significance. Canadian financed its investment in pipelines, compressor stations, gathering lines, additional wells drilled and additional leaseholds, in exactly the same manner. The Commission has generally recognized that

rate bases are founded upon actual dollars invested in property without regard to the source of such dollars, whether it be sale of stock, issuance of bonds or a bank loan, or cash on hand from any other source.

If we take the most extreme position advanced by the Commission, and assume *arguendo* that there was a pooling of assets beginning with the acquisition of such properties by Canadian, still the fact remains that $5,000,000 was paid in cash by Canadian to Amarillo for such properties. The money went *out of*, not *into*, the Project picture. **The payment did not represent the taking of money out of one pocket of Southwestern and placing it in another, as is often true in transactions between affiliates. The money came from sources entirely outside of the Southwestern holding company system. Amarillo received and retained $5,000,000 of new, outside money for its properties.** This money was clearly invested by Canadian for the properties acquired from Amarillo, and the acquisition of such properties was a condition precedent to the establishment of the entire Denver Project. It necessarily follows, therefore, however the transaction may be viewed, that this entire $5,000,000 must be considered under the facts in this case as a part of the original cost of Canadian.

Commission's "advance" or "loan" argument implies that Southwestern, as the parent of Amarillo, received 42½ per cent of the common stock and 50 per cent of the preferred stock of Colorado Interstate as full and complete consideration for the transfer of the gas leaseholds, rights and wells by Amarillo to Canadian. The fact still remains, however, that Southwestern received not only the stock interest above referred to, but that in addition thereto its subsidiary, Amarillo, received without any strings whatsoever $5,000,000 in cash. If this $5,000,000 had not been paid to Amarillo, then, on the theory of the Commission, Southwestern's stock ownership in Colorado Interstate would have been very much greater. In other words, the $5,000,000 would be an actual cash consideration over and

above any participation which Southwestern might have in any profits made by Colorado Interstate. The Record is quite clear that Southwestern's interest in Colorado Interstate was acquired in consideration of the contract between Canadian and Colorado Interstate whereby Canadian agreed to sell gas to the latter at actual cost, not only for the primary term of twenty years, *but as long thereafter as Colorado Interstate elected to purchase gas.* Canadian obligated itself under this Cost Contract to perform many other very definite and very onerous obligations. (See Canadian's opening brief, pp. 11-13.)

If we should go all the way with the Commission in its theoretical interpretation of this transaction, and assume for the purposes of argument that the situation would have been no different had Amarillo in the first instance entered into a contract, in consideration of a cash payment of \$5,000,000, to sell gas to Colorado Interstate at cost so long as Colorado Interstate elected to purchase the same on that basis, then certainly it would have been necessary in this case to have reflected the full cost of such contract in the rate base of Colorado Interstate. In that event the net result for the project as a whole would have been exactly the same, as is contended for here by Canadian. In other words, since Colorado Interstate reimburses Canadian for its actual cost of producing gas, including amortization of its indebtedness, it makes no difference to the Project as a whole whether the \$5,000,000 is in the rate base of Colorado Interstate or in the rate base of Canadian. **The important thing is that the Project participants have invested \$5,000,000 in gas leaseholds, rights and wells for the future use of the customers of the Denver Project, and at some point they are certainly entitled to a return on such investment.**

Commission's brief, in footnote 18, page 42, intimates that only a small proportion of the \$5,000,000 was actually paid to Amarillo. This assumption is based upon only a portion of the testimony of Commission staff witness Luttring.

Luttring himself clearly refutes any such assumption. He stated in this connection that his testimony with respect to the disposition of such funds was misunderstood. He said he merely desired to show that the funds were handled in the first instance by Prairie Oil and Gas Company probably due to the fact that it was a responsible person and neither Canadian nor Colorado Interstate then had banking facilities. In fact, Canadian was not then organized. Notwithstanding the Commission's characterization of the profit realized by Amarillo on the $5,000,000 transaction as "paid-in-surplus", Commission witness Luttring testified that such profit was paid out by it as a dividend to its stockholders (Southwestern), and *that the entire sum of $5,000,000 was paid to and received by Amarillo.* (R., V. 5, 2938.) The Commission also made a finding to the same effect. (R., V. 1, 150.)

The Commission predicates its entire argument not on the Record, but on the "pooling of assets" theory advanced in a decision by the Second Circuit Court in the case of *Niagara Falls Power Company v. Federal Power Commission*, 135 F. (2d) 787. This case is in no sense controlling here, either in principle or otherwise, for the reasons heretofore given and in addition thereto the following:

(1) Niagara Falls Power Company was a licensee of the Government under the Federal Power Act, and as a licensee was required to keep its books in the manner prescribed by the statute. The Act provided that the Government might recapture the properties at original cost at the end of the period of the license. Section 23(a), 16 U. S. C. A., Sec. 816, of the Act further provided, however, that where a licensee had an indefeasible right to divert water from an interstate or international navigable stream at the time the license was issued by the Federal Power Commission (which in this case was in 1921), then the licensee would be entitled to set up on its books under the recapture clause the "present fair value" of its properties at that time. This was the primary issue involved in the *Niagara* case.

The Court found that Niagara did not have a vested right to divert water from the Niagara River at the time the license was issued, and therefore its accounts were governed entirely by other provisions of the Act, which stated in detail just how the original cost was to be reflected. We, of course, have no such provision in the Natural Gas Act, and no similar situation is therefore presented in the case at bar.

(2) There was also involved in the *Niagara* case the question as to whether a sale had been made. The Court held there that a sale had not been made, but that the transaction represented merely the pooling of the assets of two companies, and that each of the original companies thereafter owned a proportionate interest in the combined assets. No money whatsoever changed hands. In this case, $5,000,000 in cash changed hands, which funds went *out of* the Project,—not *into* the Project. This fact, within itself, clearly distinguishes this case from the *Niagara* case.

(3) In the *Niagara* case the new company acquired all of the assets and business of the old companies, and continued to operate the identical properties for the identical purposes that they had theretofore been operated. In this case, Canadian acquired the properties from Amarillo for the purpose of engaging primarily in an entirely new and distinct undertaking—one in which Amarillo had not theretofore engaged,—the production of gas to be ultimately transported in interstate commerce.

(4) The Court in its opinion in the *Niagara* case very frankly admitted that many of the principles announced there "may be inapplicable to unlicensed public utilities." This is necessarily true, because it was there dealing with a statutory definition of original cost as applicable to licensees under the Federal Power Act. Such statutory requirement could have no application to an unlicensed utility, and certainly could have no application to producing and gathering properties of Canadian in this case, where

the Act itself specifically withholds jurisdiction from the Commission.

(5) But above all, in the *Niagara* case no cash whatsoever changed hands. There was no sale. In this case there most certainly was a sale, or, if we take the most extreme theory advanced by the Commission, there was a definite dedication of valuable gas leasehold properties to the Denver Project for which the sum of $5,000,000 in cash was paid. Such sum, in any event, became a part of the actual and legitimate original cost of the Project, whether viewed as an outright purchase of property or whether viewed as the acquisition of certain rights in property by way of dedication, irrevocably and perpetually, for the future use of the Denver Project.

(6) The corporate consolidation in the *Niagara* case resulted from an enabling act passed by the Legislature of the State of New York, which act provided that the capitalization of the new company should not exceed the cost carried on the books of the old companies. The Court held that for this reason there could be no desire on the part of either of the original companies to reduce the capitalization below this amount, and in effect held, therefore, that the basic elements normally present in arm's-length transactions were absent in the *Niagara* case. Certainly the Record here amply proves that there was intense arm's-length bargaining for the purpose of fixing the consideration to be paid by Canadian to Amarillo for the latter's gas leaseholds, rights and wells.

The criticism by Commission counsel of the *A. T. & T.* and *New York Telephone* cases (Com. Br., 45) is without merit. It is true that those cases had reference to accounting problems, but even so, the underlying principles there announced are even more vital in cases where a rate base is being determined. It is also true that those cases do not aid in determining whether Canadian invested $5,000,000 in the properties acquired from Amarillo, *but that fact is*

undisputed on the Record. The Commission found that Canadian actually paid Amarillo $5,000,000 in cash for the latter's gas leaseholds, rights and wells (R., V. 1, 150). Luttring, Commission staff witness, also testified to this fact, as shown by the following quotation from the Record:

> "Q. * * * Ultimately the Amarillo Oil Company received by way of credits or otherwise the full amount of the purchase price of $5,000,000?
>
> "A. Yes." (R., V. 5, 2938.)

In view of the above, the only issue is whether this investment should be recognized. On this issue, the *A. T. & T.* case is directly in point. (See Canadian's brief, pp. 66-67.)

There is no justification in any event for inclusion of properties in a rate base upon a prudent investment or original cost theory, except upon the basis advanced by Mr. Justice Brandeis in the decisions of this Court. Mr. Justice Brandeis has said that prudent investment is the money invested *to establish the utility.* We submit that such theory, as developed and applied by the Commission, has no application to the properties, business and operations of Amarillo Oil Company, whose costs have been used in this case for rate base purposes of Canadian.

Amarillo's original acquisition of gas leaseholds and its drilling of exploratory wells was a mining operation in search of oil. The expenditures made in this venture did not constitute an investment in a utility, and no utility or public service status could have attached thereto. The great value of Amarillo's leasehold properties resulted from the discovery of natural gas, which discovery necessarily and inevitably preceded any character of public service operation. Since Amarillo invested no money in a utility enterprise, the prudent investment theory, as developed and expounded by Mr. Justice Brandeis, has no possible application whatsoever.

The very first time that even a semblance of a public service status could be said to have attached to the pro-

ducing leaseholds and property of Amarillo was when they were acquired by Canadian from Amarillo for the Denver Project. This, therefore, was likewise the very earliest date upon which the prudent investment theory of Mr. Justice Brandeis could have been applied. It follows, therefore, that since the original cost or prudent investment theory is definitely inapplicable to the costs of Amarillo, the Commission is bound to allow Canadian the full $5,000,000 in cash which it paid for and invested in its gas leaseholds, rights and wells.

QUESTION 8.

Allocation.

In its opening brief (pp. 72-88) Petitioner has set forth its position on the subject of allocation and its application to the facts in this case, and it is unnecessary here to repeat the views there expressed. We submit, however, that the Commission in its brief (pp. 54-88) has made no valid answer to Petitioner's contentions.

The Commission has entered a separate and individual rate order against Canadian. Such separate and individual order is based upon an allocation which takes into consideration not the properties, revenues and expenses of Canadian, but the properties, revenues and expenses of Canadian and Colorado Interstate combined into a hypothetical composite system. If an individual and separate rate order is to be applied against Canadian, then Canadian is entitled to have that order based upon its separate and individual properties, revenues and expenses. This the Commission admittedly did not do. The properties, revenues and expenses of Colorado Interstate, or any other company, have no relevancy, competency or materiality in determining the extent or nature of the order directed to Canadian. This fundamental proposition, which is true from every standpoint, legal or otherwise, was totally ignored by the Commission, and the Commission in its brief makes no attempt to give an effective answer thereto.

There are many patent infirmities and impossibilities which grow out of the application of a composite system allocation against an individual member of the assumed composite system. It is deemed unnecessary to mention all of them here. Canadian owns and operates that part of the assumed composite system extending from the field to Clayton Junction, and Colorado Interstate owns and operates the balance of such composite system extending from Clayton Junction to Denver. It should be obvious that to combine both companies and to allocate such cost on a uniform volume basis, without regard to the distance the gas is transported, necessarily requires Canadian's intrastate customers adjacent to the field and its other non-regulable business to bear a portion of Colorado Interstate's long haul costs. For example, a total of more than $141,000 was allocated to Canadian's producing and gathering operations for federal income tax purposes, whereas the total amount allowed by the Commission in Canadian's annual expenses for such taxes was only $66,000. **Obviously, Canadian was required to absorb about $75,000 of the federal income taxes of Colorado Interstate in this composite allocation. No "end result" can be just and reasonable when this occurs.**

As heretofore stated in Petitioner's opening brief (pp. 81-83), there is absolutely no evidence in the Record upon which to base any rate reduction order directed to the sale made by Canadian to Colorado Interstate at Clayton Junction. The Commission's witness testifying on the subject of allocation (whose theories have been adopted by the Commission) totally ignored this sale. This action necessarily followed when he decided to make his allocation on the basis of the combined properties, revenues and expenses of the two companies rather than upon their individual properties, revenues and expenses. Upon consolidation into a composite system, this sale and all other transactions between the two companies were automatically eliminated. Again, as pointed out in our opening brief, when it became necessary for the Commission to find the cost of gas to Colo-

rado Interstate for the purposes of its rate reduction order against Canadian, it used a "plugged" figure which has no basis whatsoever in the Record.

Commission counsel attempt to supply this deficiency by attaching certain exhibits to their brief which purport to show what the Commission did in arriving at its ultimate conclusions with respect to allocation of cost of service. These exhibits were never introduced in evidence, and certainly cannot be substituted at this late date to supply flagrant omissions in the Commission's Opinion and rate reduction order. But even if such exhibits were given the force and effect of evidence or findings, we submit to the Court that it is still impossible to determine therefrom what the Commission did. Finally, the exhibits do show clearly that the adjustments made by the Commission were adjustments agaist a composite system of allocation (not the individual properties, revenues and expenses of Canadian), and that there still is no evidence in the Record or in the Commission's brief as to the allocated cost of service for the sale made by Canadian to Colorado Interstate. Consequently there still is no foundation in the Record or in Commission's brief upon which to base a separate rate reduction order against Canadian in connection with its sale to Colorado Interstate.

The sales made by Canadian to Colorado Interstate for resale to Colorado Fuel & Iron and other such direct sales are not subject to the jurisdiction of the Commission. The legislative history referred to and quoted from in the Commission's brief (pp. 80, *et seq.*) does not support its contention, but does directly support our contention. The purpose was to cover wholesale sales even though they were sales from one company to another "before the gas is finally sold *to the public.*" (Italics ours.)

As stated by Mr. Benton, commenting on the amendment as adopted (Com. Br., 83), "The language of the suggested amendment just proposed leaves this purpose unaffected, and makes clear that the regulation of intercompany sales

is designed for the protection of the *consuming public*, as a part of the complete regulation of the entire *utility service*." (Italics ours.) The Colorado Fuel & Iron Company and other such direct sale customers for industrial fuel purposes are not a part of the "consuming public," nor are they a part of a "utility service." Such service was not declared to be "affected with a public interest." Only the business of "transporting and selling natural gas *for ultimate distribution to the public*" was declared by the Act to be effected with a public interest, and such direct sales for consumption are by the Act expressly exempted from regulation. Why should the price of this gas sold by Petitioner to Colorado Interstate be regulated any more than the ultimate sale by Colorado Interstate to the Colorado Fuel & Iron Company? How can there be a "public interest" or a "public utility service" or "ultimate public consumption" in the one case and not in the other?

For the sake of brevity, and to avoid duplication, Petitioner adopts here what Colorado Interstate has said in its reply brief (No. 379, this Term), in so far as the principles and law therein stated are applicable to the case of Canadian.

CONCLUSION.

We respectfully submit that the brief submitted in behalf of the Respondents utterly fails to answer any of our arguments submitted in our opening brief in support of the four questions presented. No reliance may properly be placed by the Commission upon the so-called "end result" doctrine of the *Hope* case, inasmuch as it is fundamental that the jurisdiction of the Commission over the subject attempted to be regulated must be definitely established before any such "end result" principle may in any event be applied.

We therefore renew our prayer that this case be remanded, with instructions to vacate, set aside and enjoin the Order of the Commission.

Respectfully submitted,

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